either through bond issue or through the sale of stock as an ideal capital structure requires. A company of less established credit in periods of financial stress would have to confine itself to the sale of bonds if it could raise any money at all. Every period of tight money in the United States has revealed instances of companies who were unable to borrow money at all; yet, there never has been a time even in moments of panic when the corporations of the best character and best credit have not been able to borrow money either on bonds or stock.

Q. What do you mean by strengthening its capital structure——

A. The American Telegraph and Telephone Corporation has been able to finance at all times when additional capital was needed, and its requests for money have met a very prompt response; in fact, have generally been wisely oversubscribed.

Q. Well, do you mean that at such times a utility can strengthen its capital structure by increasing its bonded [fol. 3706] indebtedness?

A. That ordinarily would not be increasing its capital structure, although there are conditions when that would be true. There are times when a capital structure can be best strengthened by reducing the proportion of bond indebtedness to the total capital liabilities, and at that time stock would be issued. Now, any company which can in periods of financial stress sell stock, is strengthening its capital position.

Q. Yes.

A. It may be, however, that a company has a large amount of capital stock and a small indebtedness, and which could at that time borrow money on bonds——

Q. Excuse me just a minute. When you say small indebtedness, do you mean small bonded indebtedness?

A. Yes, small bonded indebtedness. If it could at that time sell bonds at a lower rate of interest, it would be strengthening its capital structure from the standpoint of its security holders because they would be entitled to the margin of saving between the low interest rate which the bonds carried and th- then cost of money or measure of fair return. That may not be correct in terms of strengthening the capital structure, but at least improving the balance of it. There is — a well-conceived capital structure a proper

balance between bonds and shares. A company which has no bonded indebtedness may not be treating its stockholders fairly. If they would raise additional capital through the sale of bonds at low interest rates, the stockholders would profit through the saving between the fair return and the cost of money on such loans.

[fol. 3707] The Consolidated Gas Company in its financing in the past two or three years has pointed out that fact, that in fairness to its stockholders, it should raise additional capital not through the sale of stock, but through the issuance of bonds.

Q. Do you consider the Ohio Bell Company as a utility having better than the average credit and better than the average borrowing power? You used the term, I believe, "better than the average" at two or three different points in your testimony?

A. As a part of the American Telephone and Telegraph Company, I would say that it has distinctly a better borrowing power.

Q. Yes. That comes about by reason of the license contract, does it not?

A. In part, yes The stockholders of the company are very strong financially, and have very high corporate character.

Q. You don't advocate seven per cent. as a rate of fair return to every public utility, property, do you?

A. No.

Q. For example, in the Indianapolis Water Case, you advocate for eight per cent. return, if I correctly remember?

A. Yes, for two reasons. There were many hazards confronting the company, both inherent in the utility business in which it was engaged, and of a political nature. The cost of money at that time was also higher than it is in 1926.

Q. You do believe, however, that the credit and borrowing capacity of the utility has a direct bearing upon the [fol. 3708] fair rate of return to that utility, do you not?

A. Yes, sir.

Q. Now, as I understand you, the credit position of the utility is the chief factor in determining its ability to borrow money; and of course, the better its credit position, the less the cost of money to it?

A. Yes, sir.

Q. And following that through, as I understand you, you maintain that the lower the cost of money, the lower the rate of fair return?

A. Yes; but, the conclusion which you expressed there follows only when you speak of the cost of money as the market price of money. The cost of money generally fluctuates in the money market, just as the price of commodities fluctuates. We are not, and have been for nearly two years in a period of rather unusual money ease, and there is every likelihood that that will continue for as far as we can foresee now. When the cost of money goes down because of the general financial condition of the country, the measure of a fair return would likewise go down. The margin between the measure of fair return and the cost of money would not necessarily be altered. In 1920, when money rates were much higher than they are now, I frequently testified to 9 per cent. as a measure of fair return at that time, for I know companies were unable to borrow even at 9 per cent. At this time, there are public utilities selling first mortgage bonds on a basis less than 5 per cent.; therefore, when financial and economic conditions make the cost of money lower than it has been for a number of years, the [fol. 3709] public is entitled to some benefit from that just as it is entitled to a decline in the commodity prices or in wage levels.

Q. If I understand you correctly, if we take the case of two telephone properties, both precisely the same in size, and general location, one conducted efficiently and therefore able to borrow money at an average rate of say seven per cent., the other conducted inefficiently, badly in debt as a result and therefore required to pay as high as an average of let us say 9 per cent. for the money required by it, the favorable business development and credit position of the company first described would limit it to a lower rate of return than of the second one described, on the ground, as I understand you, that the public ought to have some of the benefit of the better credit position of the first named company; is that right?

A. The public is entitled to the benefits of low money cost; but it does not follow that a company such as you have described, poorly managed and inefficiently operated, and because of that fact unable to borrow money except at nine per cent., should be given a high rate of return. Your very

question embodies within it, the suggestion for the remedy; that company should be reorganized, it should be made efficient, it should be given a good management and then when it gives good service it will be able to borrow money at as low a rate as the other company. To give them a high rate of return would be to pay a premium for inefficiency and to penalize efficient and good management, and that of course leads to an absurd result.

[fol. 3710] Q. But doesn't your testimony in part come to that?

A. No, I don't think so.

Q. That a company such as the Ohio Bell Company which you say is efficiently managed, well-conducted, is not entitled to as high a rate of return as some of the other companies not enjoying the same advantages that the Ohio Bell Company does?

A. No. The other companies that are receiving a somewhat higher rate of return are getting an eight per cent. or seven and a half per cent. return not because of inefficiency, not because of bad management or lack of public faith and confidence in their operation. They are receiving a higher rate of return because their business is less stable; there are hazards in that business, and it may be that their capital structure is such that the money they are trying to borrow will not be protected by large equity in the physical property or in the return which the company has by reason of prior security claims.

Q. Yes. Well, now——

A. The rate of return is not figured by expert opinion or even by courts at all. The money market itself figures the rate of return.

Q. The greater the equity in the property, the more protection there is to the investor in the company's stocks, that is true, isn't it?

A. Yes, sir.

Q. Yes. On page 32 of your Exhibit Number 7, you say that the cost of capital to the Ohio Bell Company should be computed on the basis of a credit structure that is correct in principle. Now, dismissing from the picture for the moment, the Ohio Bell Company and the American Telephone Company as individuals, but affiliated associate com-

[fol. 3711] panies, please state the principles which should be adhered to by public utilities of that class in order to insure to them a correct credit structure?

A. Such a utility should divide its capital so as to take advantage of its credit by using bonds to the largest amount consistent with the lowest cost of money by that form of obligation. It should have a——

Q. May I interrupt to interpolate a question there? By that I understand you to mean that the utility should borrow just as much money as possible on bonds, subject only to the limitation that it must not borrow so much as to make the interest rate on the bonds too high?

A. No, that is not the sole factor. There must be left in the capital structure, a sufficient proportion of the total in the form of equity securities, either all common stock or common and preferred, to insure a broad public interest in the management of the business.

Q. Right.

A. So far I have been talking in general terms. We can, by going over the corporate structures of the hundreds of well managed companies in the United States, and also from the examination of the capital structures of many hundreds not so well organized, see what the factors are which make for efficient and economical financing. We can analyse the companies which are successful, and find that a part of that success is due to the form in which they have distributed their various capital issues. The best results have been obtained where the proportion of the bonds is between 50 and 60 per cent. of the total capital structure, and [fol. 3712] the proportion of stock is either left all in common or divided between preferred and common stock.

Q. You believe that, do you?

A. Yes.

Q. You maintain that, do you?

A. Yes.

Q. That those companies have the best situation with respect to their capital structure?

A. In the broadest significance, yes.

Q. Yes. Excuse me for interrupting.

A. It will be somewhat over 50 per cent. in bonds; and some of the strongest, best managed companies in the United States have got as high as 55 per cent. or more, and I list quite a number of them in this Exhibit. There are some very well managed corporations in the United States where the bond indebtedness is well in excess of that, but I can cite you to instances in their financial reports where the

finance committee has called attention to the necessity of reducing the proportion of bond indebtedness, and that they must finance through the sale of stock just as soon as the market will absorb stock in order to get a better public following and to reduce the unusually large percentage of the net earnings called for by bond interest. If that is too large, the first period of business adversity is likely to bring embarrassment and ultimately receivership.

Q. You consider anything over 60 per cent. in bonds too large and as coming in that category?

A. As a general rule, I think, when the bond indebtedness is over 60 per cent. it is a warning that the company must be cautious and look forward to the time to strengthen and [fol. 3713] improve its capital structure by a better balance between bonds and shares.

Q. Does your belief in the advisability of bonds up to say 60 per cent. of the total capital structure apply to utilities generally including railroads?

A. In the first place I didn't say that I was advising or recommending as high as 60 per cent. I put it between 50 and 60 per cent., but there are plenty of strong examples around the 60 per cent. margin. I think it does apply to some of the best railroads and public utilities in the United States.

Q. Well, you did advocate 55 per cent. in bonds to the Ohio Bell Company, did you not?

A. Yes, as a well balanced capital structure.

Q. While we are on that subject——

A. Now, further answering your question, if you will turn to page 35 you will see a table there showing the distribution of the various issues in the capital structure of railroads and gas utilities. The Baltimore & Ohio, the Chesapeake & Ohio and the New York Central all have bonded indebtedness at the end of 1924 in excess of 70 per cent. The Cheapeake & Ohio has improved its capital structure decidedly by converting its large issue of bonds into stock, and that has been very favorably commended upon by the bankers. The Baltimore & Ohio suffered rather severely during 1918 to 1921 when its bonds lost their rating as available for trust fund investments in the state of New York, and required legislation to protect the credit position; and one of the reasons given was the large proportion of bonds which endangered the common divi-

[fol. 3714] dend; and when the dividend is passed the bonds lose their highest investment rating. The New York Central, in its report for several years, and the utterances of officials, called attention to the large proportion of bond indebtedness and used every means to facilities the conversation of its 6 per cent. issue into common stock, and it has since then issue- common stock, being one of the few railroads in the United States which could sell common stock in the last six years.

Q. Yes. Now, while we are on page 35, of your Exhibit No. 7, I assume that your use of that table showing the outstanding bonds of certain railroad companies is intended by you as a part of the basis for your claims that the capital structure of the Ohio Bell Company should be represented to the extent of 55 per cent. by bonds; that is true, isn't it?

A. Well, that was part of the purpose. But also to anticipate the very question which you ask, whether that was not an unusually high percentage, and I show here that it is not unusual but is present in the most prosperous railroads of the United States, and where it is not present the railroads have tried to reach the very goal that I point out.

Q. Now, I understood, from your direct examination, that you, in your organization, maintain an elaborate statistical library and are in a position to keep yourself informed of price trends and money costs, security issues and kindred matters and the most recent decisions of courts and commissions affecting those and kindred subjects; that is true, isn't it?

A. Yes. I don't know how elaborate it is, but our work [fol. 3715] requires that we give very close note and we do give constant study to the subjects you have mentioned.

Q. Let me ask you whether the Interstate Commerce Commission has not recently condemned the issue by railroad companies of bonds to the extent of 60 per cent of their total capital structure, and hasn't the Commission at the same time advocated the issuance of more common stock with less bonds in proportion; do you know that?

A. Now, what decision have you reference to; isn't that the Chesapeake & Ohio application which you refer to?

Q. I am referring to the application of the Chesapeake & Ohio Railway Company——

A. Yes. I already mentioned that one and showed what the difficulty was.

Q. Yes.

A. Now, the Chesapeake & Ohio Railroad Company, at the time it made that application, at 74.5 per cent of its total capital structure in bonds. There was exactly the kind of a case that I have in mind when the capital structure can be improved by the issuance of stock. Here was a company that was showing earnings of from 18 to 22 per cent on the stock, and why should that company go on mortgaging the remaining equity through the issuance of additional bonds when its stock was showing such a very large return as to bring about criticism of its whole rate structure?

Q. Now, let me ask you this——

A. There is a very wise division and the very thing that the railroads have been striving for for a long time; but under the trying conditions that confronted them for many years, they couldn't sell stock, and the decision of the Commission was intended to be helpful to improve just such [fol. 3716] condition.

Q. Don't you know, Mr. Hagenah, that Commissioner Woodlock in that case stated as follows: "The use of terminal mortgage bonds to secure railroad capital is an offense against the very nature of the case"?

A. Yes. He was right.

Q. Yes. "A railroad does not naturally return capital once it has been invested; on the contrary it is always engaging more capital as time goes on"?

A. Yes.

Q. Yes. "When therefore it undertakes to pay a considerable sum of money at a fixed rate under the terms of a mortgage, it can pay the maturing obligations only by raising new capital"?

A. That is right.

Q. Yes, that is right. Now then, continuing, didn't he say this: "Granted that financing by terminable mortgage bond issues may in the past have been forced upon the carriers by necessity or seeming necessity, it is certain that any road that opens itself, whereby the railroad can escape from a continuance of such a practice is a good road to take"; do you remember that?

A. Yes. Nobody has made a more intensive study of that than Mr. Woodlock has. He was advocating that long before he went on the Commission.

Q. Didn't he say this further: "Two generations of this sort of financing have left most of the carriers of the United States with capital structures overweighted with fixed terminable obligations carrying rights of foreclosure. About 60 per cent of railroad investment is represented by securities of this class."

A. Yes; that is unfortunately true.

[fol. 3717] Q. Yes.

A. If I wanted to fix something that showed more than 60 per cent, I could have given a list that would more than fill this page, but they are not the roads that I credit. Look down the report on page 35 and see if you can name a high grade railroad in the United States which is not listed there or one that is there which doesn't have a high credit.

Q. Yes; but there he condemned the 60 per cent of railroad capital structure represented by bonds.

A. Exactly. And the railroads didn't increase their capital structure for bond indebtedness to the high figure which Mr. Woodlock mentions because of their own choice. Let us get the reason of this. Since 1912 it has been almost impossible in the United States to sell railroad stock; their earnings have not been large enough, and you can't ask people to put money into the stock of a railroad when that railroad is already in distress and is having difficulty in paying dividends on the limited capital which it then has. There was nothing for them to do but to bond the remaining equity of their property, or to go without their money. The public clamored for extension of railroad, but wouldn't put the money into their stock and become a partner of the enterprise. That brought about the deadlock which brought about the legislation in Congress. The utilities which had splendid administration of local commissions would get increases in rates promptly. The 60 per cent on page 35 is not typical; that is the result of the strong ones. I could mention some where the percentage was very much larger. But take the different classes of public utilities where the [fol. 3718] Commissions operated more promptly and the machinery of regulation met the extraordinary conditions of the war, utilities were able to sell stock and the situation is by no means so bad. Here we have gas companies with an average of 57 per cent in bonds. We have electric and

power companies with an average of 51.6 per cent. We have joint gas and electric companies with an average of 54.8 per cent, and the public today is willing and ready to absorb and is absorbing increasing amounts of public utility stock and bonds.

Q. Well, isn't it true——

A. By the way, let me call attention to one fact that should be mentioned on page 35. You will notice that the average for gas companies is 57 per cent. There is one company, the Washington Gas Light Company, which has a percentage of bonds as high as 78. That is not a fair capital structure. The amount of capital stock in that company is exceedingly small; the market price is very high. The company has been reinvesting its surplus earnings each year and has not put out capital stock. I recently made an appraisal of that property. The value is far in excess of the combined bonds and stock, and the company must soon go through a recapitalization and could issue a large stock dividend, but because of certain restrictions that obtain in the District of Columbia, that has not been changed.

Q. But isn't it also true that the railroad financial situation differs from that of public utilities generally with respect to their bonded indebtedness in that in the case of a [fol. 3719] railroad by far the greater portion of their new outstanding bonds were issued long before the war at lower rates of interest than those which have prevailed since that time and which now apply to public utility bonds generally?

A. That is true; and the situation became bad because the last 12 or 15 years about the only securities they could sell were equipment issues which were in the nature of bonds, and made a structure that was reasonable enough in 1910, topheavy in 1924, and at the time Mr. Woodlock made his announcement in the Chesapeake & Ohio application.

Q. Now, don't you know, as a matter of fact, Mr. Hagenah, that the Interstate Commerce Commission really advocates a minimum of bonds; that is the smallest possible bonded indebtedness of a utility; in fact the Commission really leans toward a financial construction have no bond at all but entirely stock; isn't that true?

A. No, I don't understand that to be the fact. Certainly decisions of the Commission and the act of Congress wouldn't make that a consistent position. How can you possibly get money to go into railroads under the Interstate

Commerce Commission's findings as to their value, and other aspects of regulation, while utility commissions for the last ten years have almost unanimously accepted a reproduction cost less existing depreciation as a basis for rate making. The Interstate Commerce Commission is now contesting in the first final case that has gone before the United States Supreme Court that the value of railroad properties shall be on the basis of its value made on prewar price levels. People are not going to put their money [fol. 3720] into railroads as long as that remains open; and for the Interstate Commerce Commission to say they should put money in and then make it not attractive to put it in, is merely a deadlock. That is why we have a better position in utilities than in the railroad structure.

Q. Now, I asked you a moment ago whether the Interstate Commerce Commission didn't really advocate a minimum amount of bonds and as much stock as possible in making up the capital structure of a utility. Are you familiar with the order of the Interstate Commerce Commission in the case of the application of the Pittsburgh and West Virginia Railroad Company for leave to issue a certain number of shares of common and preferred stock, financial docket No. 5244 of the Interstate Commerce Commission decided March 22nd, 1926, a little less than a year ago?

A. No, I am not familiar with that case.

Q. You don't know that in that case the Commission said, "It must be conceded that the applicant's capital structure as now constituted, approaches the ideal. It has no bonds outstanding, and aside from $2,700,000 of equipment trust certificates which will mature serially over a nine year period, its sole capitalization is represented by $30,235,100 of common stock consisting of 302,351 shares of the par value of $100 each." You don't recall that?

A. I don't recall that. But there are facts in that particular railroad that you speak of that might make that decision almost unavoidable.

Q. Well now——

A. There are so many aspects of the form of a capital structure, what is ideal under one set of circumstances and [fol. 3721] ideal under another, that I really cannot answer the question without going into a very lengthy explanation even of financing which probably has no place here; but I won't agree that an idea- capital structure for a public utility like the Ohio Bell Telephone Company is one consist-

ing of stock only; and in that conclusion I seem to be fortified by the judgment of the overwhelming majority of the people who are engaged in financing the best public utilities, because they are all placing those bonds at the lowest possible rate in an attractive money market, and the public is taking them with great promptness.

Commissioner Maullar: We will recess at this time until 1:30.

And thereupon a recess was taken until 1:30 o'clock P. M. of same day. (Wednesday February 16th, 1927.)

[fol. 3722] Afternoon Session

Wednesday, February 16th, 1927.

And also WILLIAM J. HAGENAH, resuming the stand for further cross-examination, continued his testimony as follows:

Cross-examined by Mr. Burr:

Q. Still referring to the question of fair return; it is true, is it not, that the general financial policy of the Bell System as indicated by the bond issues shown on page 44 of your Exhibit, is to issue bonds to the extent of but little more than 25 per cent of the total capitalization?

A. The figures shown in my report is 26.9 per cent.

Q. Yes. Would you call that conservative financing?

A. Yes, it is conservative; but it is rather expensive, because the company could raise a larger percentage of its total capital requirements through the sale of bonds and at the low carrying charge which such bonds carry.

Q. Well now, isn't the ability of the Bell system to borrow money on bonds at a fraction over 5 per cent due to the very fact that their bonded indebtedness is restricted to only 20 or 25 per cent of their capital structure?

A. No, I don't think so. I think other companies that have bond indebtedness of over 50 per cent are putting out their securities at as favorable a cost as the telephone utilities where other features are present in like proportion; as for instance earning power and territory supplies, form of [fol. 3723] regulation, etcetera.

Q. Would you, as an investor in utilities securities, regard as favorably an 8 per cent common stock under a financial

structure providing for 55 per cent of bonds and 22½ per cent of common stock as you would a financial structure providing for 26.9 per cent of bonds and 52.4 per cent of common stock?

A. Yes, if other conditions were equally attractive. I think an 8 per cent security such as you mention would be as good an investment as one where the bond issue was a different proportion than you have mentioned.

Q. Notwithstanding in the first case the outstanding bonds of the company which are a lien on its property and is what you pay before anything goes to the common stockholders amount to twice as much as the outstanding bonds in the second case?

A. Yes; I think the spread that you mention there is not sufficient to materially affect the investment value of the stock if other conditions are favorable. I can show that to you by going through certain of the securities that are listed on page 35 and 36 of my Exhibit where the common stocks bearing 8 per cent dividend are selling on as high or higher basis than those of the telephone companies, and where the proportion of the bond indebtedness is in excess of 50 per cent.

Q. I only wanted your opinion, but I will ask you this: are those cases wherein, in addition to the 58 per cent of bonded indebtedness ahead of the common stock, there is also 22½ per cent of preferred stock ahead of the common [fol. 3724] stock?

A. I am unable to say from memory what the proportion of the preferred stock is.

Q. Can you find any instance in your Exhibit there of companies having 55 per cent of bonded indebtedness, 22½ per cent of preferred stock and 22½ per cent of common stock?

A. No, not exactly that, because I am dealing with averages; but there are plenty of instances of the type from which I arrive at my conclusion. The preferred stock, which is ahead of the common stock in the capital structure I used for my conclusion, bears only 7 per cent. If it were all 8 per cent the charge would be even greater.

Q. Well, do you want this Commission to understand that you, as an investor in public utilities securities, would regard as favorably an 8 per cent common stock with 77 per cent of bonds and preferred stock ahead of it as an 8 per

cent common stock having only 48 per cent of preferred stock and bonds ahead of it?

A. There are so many other factors that have to be taken up in determining upon the investment rate of the securities other than what you have mentioned. If you would refer to——

Q. Let us consider two Bell system companies side by side, the same companies, same size and the same conditions exactly except that one has 55 per cent of bonds and 22½ per cent of preferred stock, and the other has 26 per cent of bonds and 22½ per cent of preferred stock.

A. If everything else were the same as to the items which you have not mentioned but which are present in determining the investment rating of a security, I would, from a standpoint of security alone prefer the stock that had the [fol. 3725] smaller amount of bonds and preferred stock ahead of it.

Q. Of course.

A. But if all the other conditions were present that stock would be selling at a much higher market price.

Q. But suppose the conditions are exactly the same with respect to both companies, size, operation, return, and the only difference in them was in the capital structure in the respects that I have pointed out; the only difference?

A. Then the only question that I would have to deal with is whether I would want to pay the extra premium which the market attached to the security having a smaller bond indebtedness.

Q. I am not asking that.

A. But the market would fix that. If you prescribe the factors, then the conclusion is right only as it follows the conditions which you prescribe. You are asking me what, by way of illustration—you are in a way fixing the angles of a triangle and then asking me to answer in terms of lengths which would make such a triangle impossible. But taking the two securities, you say they are alike in all respects——

Q. I say the companies are alike in all respects.

A. The companies are alike in all respects except that the common stock in one case is preceded by a 55 per cent of the capital structure in bonds and the other 26 or 27 per cent.

Q. Yes; with the same amount of preferred stock in each case.

A. Yes. Then you objected to my answer because I say that the stock in one case would sell materially higher than the other.

[fol. 3726] Q. No, I don't object to that answer at all.

A. Then my problem would be a simple one. I come back and answer it as I did before. My only question then is whether I want to pay the extra premium which the market would place on the stock which had a smaller bond indebtedness ahead of it.

Q. Isn't the very fact that in the first case where there is 55 per cent of bonds and 22 per cent of common stock or a total of 77 per cent as against 48 per cent for bonds and preferred stock in the second case, isn't the fact of that difference the reason why the common stock of the second company will sell at a premium and because you have got to pay more for it—isn't that the reason you have to pay more for it?

A. No, that is not the only factor.

Q. Isn't that one of them?

A. That is one of them, yes; I said it was not the only one, thereby I admitted that it was one of the factors. But if you will go with me over the list of securities on pages 35 and 36, I think I am familiar with enough of them that I can show you the determining characteristics which determines their income yields and investment ratings.

Q. All I am asking for is two companies in exactly the same situation; and you have said, as I understand it, that in the case of the company having the smaller total of bonds and preferred stock ahead of the common stock, the common stock would be selling at a higher price; you would have to pay a premium for it over and above the price you would have to pay in the case of the company having 77 per cent.

[fol. 3727] A. It would be more attractive as an investment holding.

Q. Yes.

A. But it would cost you more, and in terms of yield, it would bring you back again to the start. What we are dealing with is the cost to the company of the capital. The market automatically adjusts itself to the characteristics which you have mentioned, and that is present in all these securities listed on pages 35 and 36, and they are only examples of a list that could be made very much larger. But I want to say, in answer to these questions, that if you will

refer to the Moody Service which is embodied in its annual report known as "Moody's Investors' Reports On Public Utilities" you will see that before a security is given a definite rating there are many factors that are taken into consideration besides those which you have declined in your question to me and which I intended to cover.

Q. You propose a financial structure for the Ohio Bell Company involving or including 22½ per cent of common stock. What ones of the utilities cited by you with approval at page 37 of your Exhibit, have as small an amount of common stock as 22 per cent of the total capital structure?

A. They are all listed there on those pages. I can go through them.

Q. Yes. Now in every case but one the company has a common stock of from 32 to 37.9 per cent of its capital structure, hasn't it?

A. No. There are quite a number of exceptions to that. They are all listed. Of course, understand, and this is vital to your question, that the separation of the stock between preferred and common is purely optional with any company, [fol. 3728] and is not an important feature in the capital structure to which I am directing attention. The important part is what percentage is in the form of bonds and stock; in other words separation between creditor securities and partnership securities. Now, if you want to issue preferred stock which has prior lien on properties in liquidation or claim on earnings for dividend payments, the stockholder in the common division must surrender something in return for which he wants a larger dividend.

Q. Well, I recognize the importance of what you say from your standpoint, but the importance of my question from my standpoint is this, if you please; that of the companies listed on page 37 of your Exhibit there is not one of them that has as low a percentage of common stock as the 22½ per cent. which you advocate for the Ohio Bell Company in this case; that is true, isn't it?

A. Are you right as to the page, 37?

Q. 37.

Mr. McConnaughey: Don't you mean 35 and 36?

Mr. Burr: No, sir, 37.

The Witness: Those are group securities and I can't pick out the individual companies.

Mr. Postle: That is certainly wrong.

Q. Well, have it your own way, groups if you like, and I will put the question this way. Where, in any one of those groups of securities is there a company group having a percentage of common stock as low as that which you advocate for the Ohio Bell Company in this case?

[fol. 3729] A. There is only in the case of joint gas and electric companies that that percentage is approximated. But we are dealing there with averages. But the important matter is that the proportion of the bonds of all those companies is 54.8 per cent. as against the 55 per cent. which I suggested. In fact, that is the source of the 55 per cent. idea. The separation between preferred and common stocks is purely a matter left with the companies. If they want to give a priority, it is their privilege to do so. These are old companies. The issuance of preferred stocks is a rather modern and recent development that has been brought about through the customer ownership movement in the last four or five years; in fact an outgrowth of the war conditions and its limited credit capacity when companies had to turn to their own subscribers for financial assistance. You will find the companies which have had to do most borrowing are the ones who have developed the plan to a larger extent, and if you take that into account you can't find anything that will be a guide to 1926. But in the last two or three years you will find plenty to sustain the suggestion I have made.

Q. You say the matter of the division of the capital structure as between preferred and common stocks is one for the companies to determine. You have determined in this case that for the Ohio Bell Company that shall be on the basis of 22½ per cent. each of preferred and common?

A. That is a simple division of half and half.

Q. Well, let us see how simple it is. Suppose you had put all of the preferred stock into the common stock column [fol. 3730] so that there would have been 45 per cent. of common stock at 8 per cent.; that would have affected your whole computation, wouldn't it?

A. It would have affected it.

Q. And would have brought out your fair return answer to something a little over 8 per cent., wouldn't it?

A. Well, I haven't the mathematics of that before me. I would be surprised to find it as high as that. I think it would be over 7 per cent. instead of 8 per cent.

Q. Well, whatever it would be it is a matter of computation?

A. Well, it wouldn't in fact be the 8 per cent. which you mention, but it would be somewhat higher than 7 per cent. In the interest of proper financing it is good practice to issue preferred stock, and it is good practice not only from a cost of money and rate of return standpoint, but from stock interest, stock partnership in the business. And carrying your example further; suppose there were no bonds issued at all, and all common stock; I believe there would be no authority would say that under those circumstances the company should earn enough to pay an 8 per cent. dividend on all of its capital stock with that degree of surplus protection which anyone would admit the company should have. That would mean a return of 10 per cent. Now, there is science in building up a capital structure just as in the designing of a telephone plant. The American Telephone and Telegraph Company applies that science to an unusually favorable degree in designing and supervising its plant. The company pays for that in the form of an inter-company relation. It is enabled to receive financial assistance in its [fol. 3731] financial structure. The experience of the company under that contract, speaking of the American Telephone and Telegraph Company and its subsidiaries as a whole, justifies the financial set-up which I here show, and it is one that will enable the company to pay bond interest and amortization of discount and expense in the proportion in which the company has to pay it. It will enable you to pay the 7 per cent. on preferred stock, to pay 8 per cent. on your common stock, with such margin as bankers and security underwriters think is necessary to make those securities attractive in the investment market. It is that sort of a capital set-up that the telephone subscribers are paying for in the payment under the 4½ per cent. contract. If they had to pay the same price which companies not benefited under such a contract have to pay, there would be no purpose in having the contract.

Q. Well, let us look at that a moment. I think that you said that ordinarily a public utility is entitled to a rate of per cent. of at least 8 per cent., didn't you?

A. Ordinarily, generally speaking.

Q. Haven't you so testified from time to time in other cases?

A. Yes, I have in individual cases; and always in respect to the then money market and the form of securities that the company would issue, and the kind of a utility that I was talking about.

Q. Well now, in some of them you have advocated as high as 9 per cent.?

A. Yes; and in some as low as 7 per cent.

[fol. 3732] Q. In this case, however, because of the financial services, largely because of those, and the fact that the Ohio Bell Company has the benefit of the license contract, you say that in this case the return should not exceed 7 per cent.?

A. I think 7 per cent. is a fair figure.

Mr. McConnaughey: Do you accept the reasons that he gives for that in his question?

The Witness: What are those?

Mr. McConnaughey: I don't believe he intends to.

(Question read.)

A. My answer to that was in the affirmative.

Q. Yes.

A. But I am making my answer in the light of the financial conditions of 1925 and 1926.

Q. Yes.

A. And I can't determine the rate of return disassociated from the cost of money as disclosed by the selling prices of securities having like investment characteristics.

Q. Well, now, on a basis of a fair value for rate making purposes of $125,000,000, that difference of 1 per cent. amounts to $1,250,000 a year to the company, doesn't it?

A. Yes, sir.

Q. Yes. Now, the license contract payment according to Morse Exhibit No. 16 for the year 1926, amounted to $1,277,000 in round numbers?

A. Yes.

Q. And you have already said, I believe, or you have evaluated the instrument services under that contract at something like $400,000?

A. No, I haven't disturbed the payment to the parent company under that contract at all. I merely distributed [fol. 3733] it in your books in a different way. I do not want to appear as criticising that payment because I do not know what its true value is. I merely know it is a valuable contract.

Q. Yes. But you evaluated—not terminated, evaluated the instrument service part of that contract at about $400,000 as I recall it; somewhere thereabouts?

A. I think that is right.

Q. Yes. And of course, in addition to that, there are a great many other services which the company gets under that contract?

A. Yes.

Q. And yet, when it comes to the matter of fair return you reduce the company's revenue by approximately a million and a quarter dollars due to the fact that the company is one of the associated Bell companies and has the benefit of the license contract?

A. No, that is not true at all.

Q. Doesn't it come to that?

A. No, it doesn't, because you overlook the most important single factor in determining the measure of the fair return at this time, and that is the money market at the present time. I have with me the data if you care to go into it, that shows what a larger decline there has been in the cost of money to public utilities over the last three years. If you will take the decisions of public service commissions which hold an 8 per cent. rate of return, you will find that those are all based on the cost of money to the utilities at the time of investigation. That is proper. The appraisals were also made on the cost of materials and the wage scales which obtained at that time, and the Supreme [fol. 3734] Court said that was proper. When the cost of materials and wages rises it is proper that that be reflected in the valuation or rate base. When the cost of money went up it was reflected in the rate of return allowed; when prices go down it must also be reflected in the value for rate making purposes, and when the cost of money for financing purposes goes down, the rate of return must go down, too. In allowing a lower rate of return, the margin or spread between the cost of money in the open market and the rate of return allowed by the authorities were not necessarily reduced because a 7 per cent. rate of return is now allowed as compared with an 8 per cent. 4 years ago.

Q. Yes. Didn't you, when you were discussing the item of going value, say that you arrived at the figure of $16,000,000, one of the methods described in your evidence, by "Evaluating the value of the property on the difference in the rates," and didn't you also say "That method, however,

must be qualified by the fact that in 1925 we had an exceptionally favorable financial market"?

A. Yes.

Q. Yes. In other words when, in the matter of the valuation of going value you reduced your amount of going value due to what you say was the exceptionally favorable financial mark , and here in the matter of your fair return you reduce the fair return because of what you say is the exceptionally favorable financial market?

A. I have reduced the fair return because the cost of money has gone down. It is summed up somewhat in this manner, because of the several questions which you have asked. The Ohio Bell Company receives certain very defi- [fol. 3735] nite and substantial benefits under the contract with the parent company. That company has as high credit as any public utility in the history of the Industry. By reason of that contract the local company is charged approximately $1,200,000 a year and that item is included in the cost of operation here. I have not disturbed that payment to the parent company. If the public here is to be charged for the cost of the contract and then not to receive the benefits of the contract which it has paid for, what is the benefit to the public of the contract for which it pays $1,200,000 in the operating cost? Having paid for it, they are entitled to the natural benefits of their bargain.

Q. Yes. As I understand it——

A. If I were to exclude the million two hundred thousand dollars or suggest that it should be excluded in its entirety, and then reduce the rate of return to 7 per cent. I would be inconsistent. But by including in the operating expenses the premium of the contract, I believe the public is entitled to the benefits which it bought under that contract. To come to the other side of the situation, if the cost of money should rise, I would promptly call attention to the advance of the cost of money and express the belief that a higher rate of return was necessary to attract capital.

Q. What does your exhibit show as the percentage of [illegible] value of the railroads listed on page 30, [illegible] page 674,

([illegible] relating to railroads alone?

Q. Yes.

A. The [illegible] of the 18 railroads shows 34 per cent. [fol. 3736] of the capital structure represented by common stock.